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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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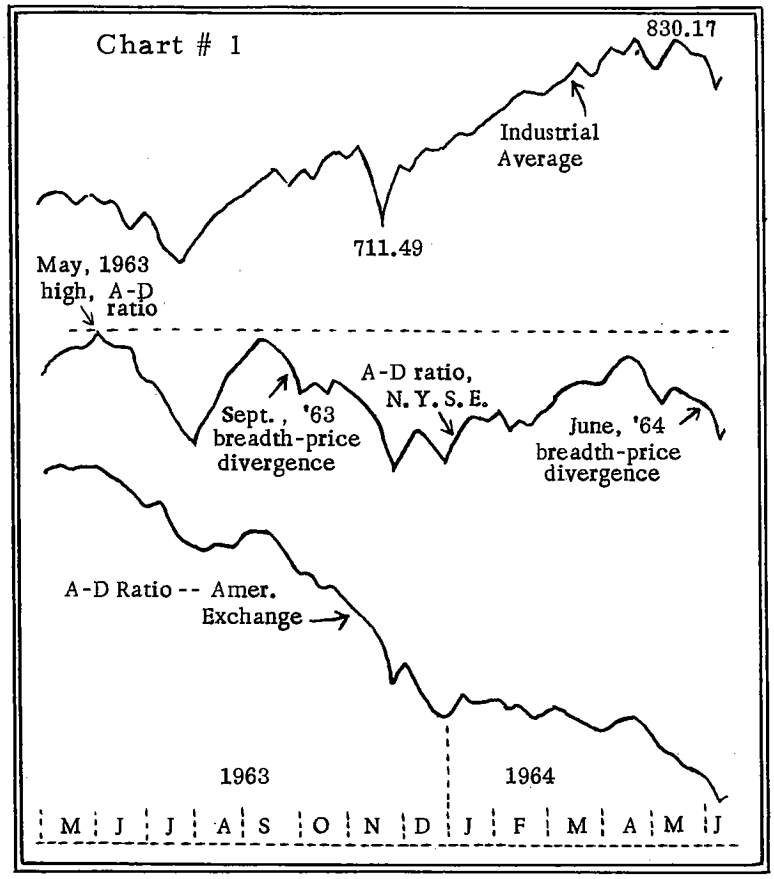
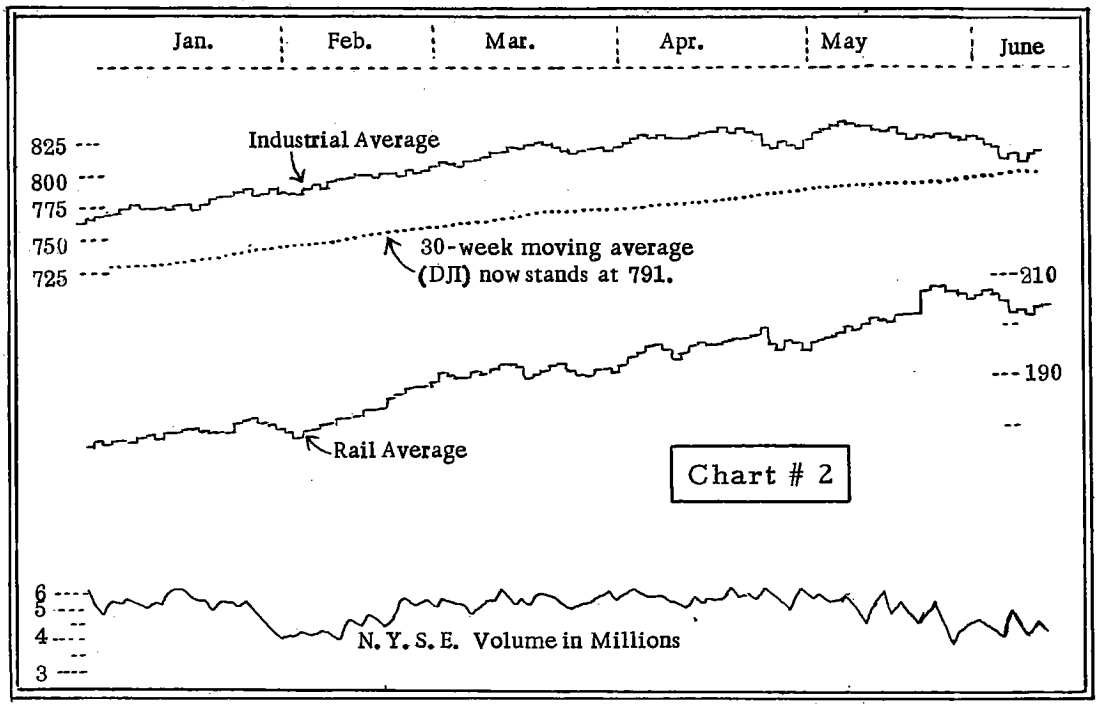
THE MARKET: Throughout the past year market propagandists have been generating enthusiasm through the use of such tools and statements as the "reasonable" price-earnings ratio in the Industrial Average (historically not true), the new high in the weekly advance-decline ratio (the weekly ratio is a deceptive instrument and this writer has avoided it), great metal and ore discoveries (and I have no doubt that they are great), fabulous auto sales (which have been fully discounted by auto stocks), booming personal income, a tax cut (evidentally fully discounted), a building boom and a new President who is held by his admirers to be a mixture of Andrew Jackson and Franklin D. Roosevelt. To add to the enthusiasm, the Industrial Average pushed a deceptive 2% above its first quarter (March 17) peak on May 7, an event which was widely heralded as a "confirmation of the rising market trend."



For the handful of analysts who have not cared for the market action of the past year, it is now interesting to watch the "tunes change" as the cracks in the market's technical structure become more obvious, and as very elusive profits turn into unpleasant losses. Even the financial advertisements begin to reflect the true situation as noted in this opening from a June 8, Barron's ad: "Few markets have been as discouraging as this one. Stocks with bright outlooks decline persistently. Technical breakouts develop into technical traps. Standard indicators conflict. The advance-decline ratio on the American sinks lower and lower." My friend Joe Granville asks in his current Barron's ad: "Has the Cinderella market turned into a pumpkin?" And of course he knows, as do readers of this Letter, that this market has been a mixture of lemon and pumpkin for quite some time.

* * * *

On May 7 the Industrial Average recorded an historic high of 830.17 (Chart 2). This was followed by an immediate decline in the senior Average, but despite Industrial weakness the Rail Average continued to rally, establishing an all-time high of 207.31 on May 21. The divergent action in the Averages was commented



 upon in Letter 254, which stated: "This 'parting of the ways' is usually indicative of 'internal tension' within the market, and the movement following a protracted divergence can be violent."

Subsequent to the May 21 Rail peak, the entire market turned weak. It was obvious that the Rail Average had finally decided to follow the Industrials down. June 4 saw the worst market break since the "Kennedy assassination panic". By the close, Industrials were down 9.31 points at 802.48, Rails were down 2.75 at 202.65.

From the standpoint of Dow's Theory, a period of divergence has occurred, following which the two Averages have traced a definite downward zig-zag pattern. This type of pattern strongly suggests that the secondary trend has turned down.

It should be remembered, however, that it is what occurs after the first (upward) correction of the initial decline which will determine the seriousness of the situation. The last confirmed highs in the Averages occurred on May 7. The time is approaching when a correction of the downward movement should begin. Following the correction, if the two Averages rally to new highs (above 830.17 and 207.31) the continuation of the main bull movement will have been signalled. Conversely, if the two Averages (following a full corrective rally) then turn down and break whatever lows are now being established, then Dow's Theory will have signalled the existence of a bear market.

SHORT TERM: Breadth declined on 9 out of the 11 trading days between May 22 and June 8. This acute downward compression called for a temporary reversal with perhaps a 1/2 to 2/3 retracement of the Industrial decline. Since the Industrial drop from the May 7 high to the June 8 low was approximately 30 points, it would not be surprising to see the current rally take Industrials back to the 810-820 level again. From the standpoint of the mass of issues, however, at the June 8 low it was obvious that the A-D ratio had broken so badly (Chart 1, page 1) that recovery from these levels would probably take the form of a correction against a major and continuing slide in breadth.

BREADTH-PRICE Four separate factors point to the current dangerous market situation: (1) the protracted divergence in the two Averages prior to the decline; (2) the fact that the Industrials have fallen out of a bearish "broadening formation" (see later section); (3) the "in gear" decline of the two Averages following the divergence, and the Industrial decline below a three-month (810-830) trading range; (4) last, but very important, the fact that the second breadth-price divergence of the past seven months has been completed.

A breadth-price divergence is a technical abnormality; it is the market's way of saying that although the patient appears to be all right, he is running a fever. The divergence is caused by the persistent refusal of the majority of stocks to follow the lead of the Industrial Average. This is in contrast to "normal" market action in which the tendency is for all stocks to move together.

On June 2, 1964 (see Chart 1) the A-D ratio broke below its April 30 low. As discussed in detail in the last Letter, this penetration of the April 30 low completed the bearish breadth-price divergence. On June 4 another sweeping decline added fuel to the bear case by taking the A-D ratio to a new low for 1964. On that day (June 4) the breadth index dropped to its lowest level since December 31, 1963, at which time the Industrial Average stood at 759.90.

What is implied by the completed price-breadth divergence of June 2 and the new 1964 low in the A-D ratio? Breadth-price divergences have (in the past) generally been followed by two or more broad downward sweeps or "selling climaxes". Furthermore, a breadth-price divergence usually marks the beginning of a series of movements which ultimately put breadth and price "in gear" on the downside. This "getting in gear" is usually accomplished in one of two ways: (1) The A-D ratio breaks to successive lows, but these new lows are not confirmed by the Industrial Average. Each unconfirmed low in breadth is followed by a rally, and during these rallies (even though breadth is poor) Industrials may actually rise to or above the old high. But such strength is deceptive and is almost always the prelude to a collapse in the senior Average as it finally confirms (gets in gear) with the A-D ratio on the downside (as in 1957 following the 1956 "double top"; and as in 1960, following the unconfirmed Industrial highs of 1959).

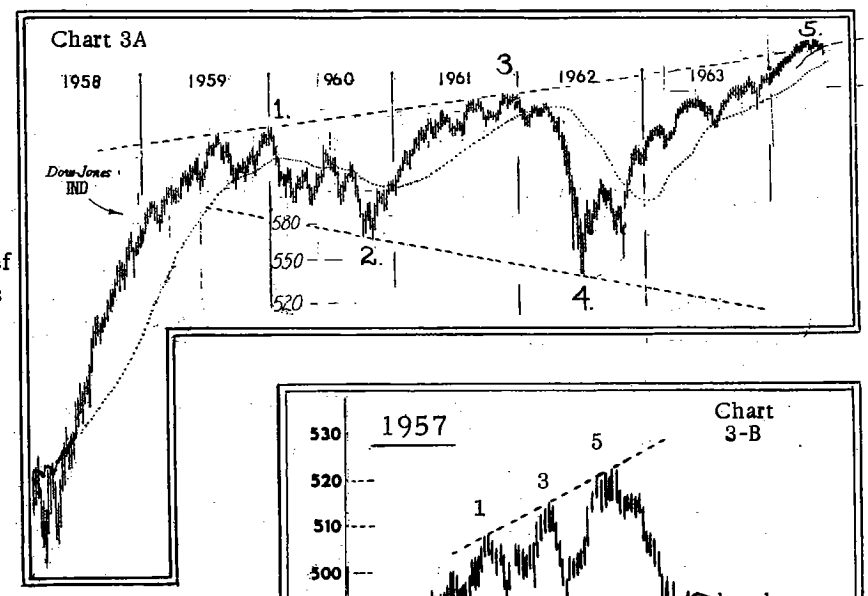
(2) The other type of resolution of a breadth-price divergence is an immediate "getting in gear" of both price and breadth as was the case in 1929, 1937, and 1962. In 1962, for example, breadth broke badly in March, 1962, dropping below its entire 1961-62 range. This bearish action was immediately confirmed by the Industrial Average which, during April, 1962, plunged below its own 1961-62 range.

What of the current situation? The A-D ratio has been "out of gear" with Industrials for over a year (Chart 1). Following the September, 1963, divergence, the A-D ratio dropped to its lowest level since January, 1963. A new advance carried Industrials to 830.17, but the A-D ratio refused to better its September, 1963 high. On June 2, 1964, a second divergence was completed, following which the A-D ratio wiped out all of its 1964 gains. With the A-D ratio continuing its very weak performance, it is a question of whether Industrials are going to "keep fighting" or whether they are going to follow the bearish lead of the A-D ratio. Meanwhile, the grim (and profitless) struggle continues. An outstanding buying opportunity will appear following the inevitable decline which will serve to get Industrials and the A-D ratio in gear again.

TECHNICAL COMMENTS: Daily new highs and lows have been confirming the general market weakness. On June 9 the five-day average of daily new highs dropped to 19, lowest level of the year, while the five-day average of new lows expanded to 71, highest since the Cuban crisis (October, 1962) and actually higher than the 69 figure registered at the Kennedy panic low (November, 1963).

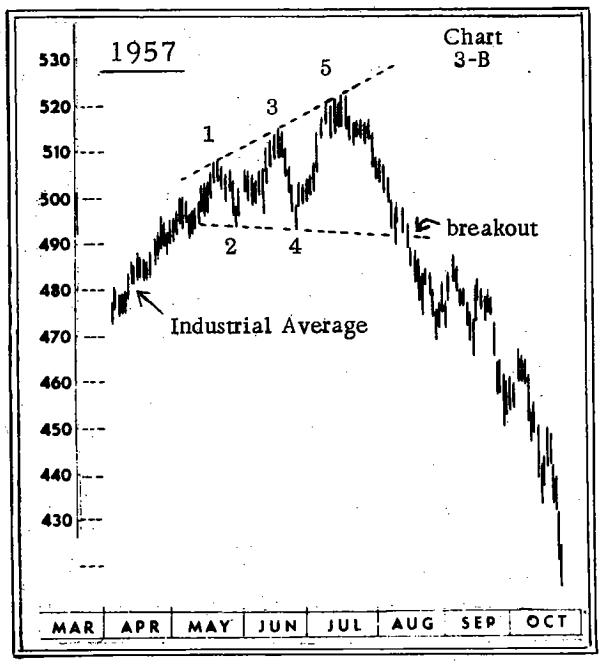
This is another particularly interesting commentary on breadth (courtesy of Joe Granville). On May 28, 637 Big Board issues closed within two points of their lows for the year. This means that almost half of the N.Y.S.E. issues could sink to new lows if downward pressure is resumed. Subscribers should remember, however, that this type of broad market weakness serves one valuable function; it allows us to comb our relative strength charts and pin-point those stocks which are bucking the downward trend. These are the issues which are most likely to lead the market on the next rally.

BROADENING FORMATIONS: The rare "broadening pattern" has been discussed here before. The pattern consists of an expanding five-point reversal formation — each peak above the last peak and each low below the last low. The writer has made frequent reference to the giant broadening formation which has been traced out by the Industrial Average since the 1959 peak (Chart 3A). It has therefore been fascinating to watch the Industrials as they literally "walked along" the upper trendline of the great broadening structure over the past few months. The continuing question, of course, has been: will Industrials "break away" on the upside, or will the broadening structure be completed by a major decline which might take Industrials below the lower trendline at point 4? As of last week, the senior Average "threw cold water" in the face of the bulls by dropping decisively below the rising trendline (Chart 3A). Incredibly, the drop was accomplished by completion of a smaller broadening pattern which occurred within the framework of the larger one (see paragraph below).



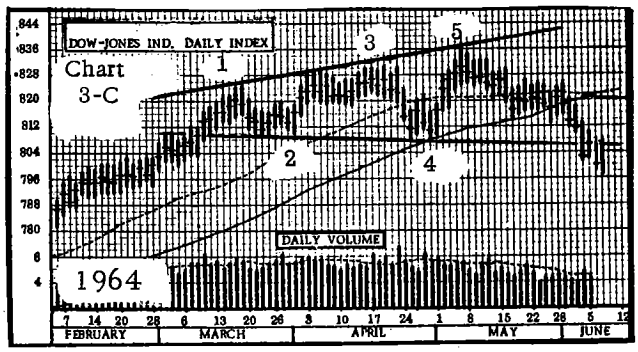
Despite recent widely-publicized but unorthodox interpretations, broadening structures are usually bearish, and, in fact, approximately 90% of all such patterns are resolved on the downside. The broadening pattern is the product of an excited market — one which is being "whipped up" by tips, rumors and gossip. The appearance of many broadening formations in 1929 gave rise to the belief that these patterns were extremely dangerous. This writer holds them no more bearish than any other distributive pattern, but the fact that broadening tops usually occur during the late (speculative) stages of a bull market suggests that they are important "topping out" patterns.

Broadening patterns are usually associated with individual stocks. The only broadening top heretofore completed in the Averages occurred in the Industrial Average during May-July, 1957. For the benefit of readers, I have included a daily chart of the 1957 broadening Industrial structure (Chart 3B). From point 5, which was recorded on July 12, 1957, the Industrial Average dropped 20% in a period of three months.



The recent three-month broadening top was completed on June 4, 1964. This is illustrated on daily Chart 3-C. Whether the resolution of the March-May, 1964, broadening pattern will follow along the 1957 lines remains to be seen. Suffice it to say that this extraordinary market has produced another rare phenomenon — the second (completed) broadening top in the history of the Averages.

SUNDRY OBSERVATIONS: It is always interesting to try to understand the meaning behind the events. The London Financial Times reports the following situation: The French are seeking a return to the gold standard, with a substantial increase in the price of gold to make it possible. If they cannot have the gold standard, the French want any change or changes which will allow them to get rid of their dollar balances, to weaken the use of the dollar as a reserve currency, and to "shift the center of international decision farther from Washington to Paris."



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In this writer's opinion, DeGaulle views the U.S. inflationary trend as a force which may eventually undermine the U.S. as an important power in international politics. Historically, world power has always gravitated to the gold-rich nation or nations. DeGaulle is well aware of this (and he is also aware of the ironical fact that Washington would now like to

scrap that last bond to fiscal responsibility — the 25% gold clause). DeGaulle sees events pointing to new leadership in Europe and perhaps in the entire Free World — France.

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As an interesting commentary on the seriousness of the Franco-American situation, under the title "Growing U. S.-French Rift Indicated at Hawaii Talks", the New York Times (June 4, page 1) goes so far as to state that U. S. diplomats at the Hawaii meeting "share the estimate of their colleagues from Washington that the French were working to thwart and perhaps even to sabotage U. S. policies in Southeast Asia."

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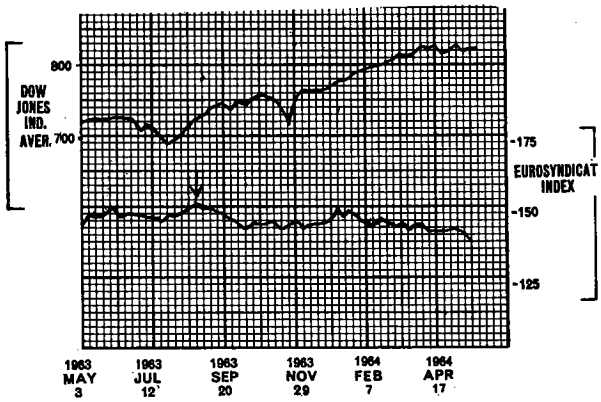
Whether it stems from political or economic sources or both I do not know, but major foreign exchanges are reflecting potential trouble in the wind. The Australian, Austrian, Belgian and French stock Averages (see Letter 248) have recently fallen to new bear market lows. The Italian market has recovered slightly from its recent panic low, while the German market is still only halfway back to its major 1960 high. The British Average, after forming a "double top" earlier this year, has now given up half its 1964 gains. A fairly good picture of the entire European "blue-chip" sector is provided by the Eurosyndicat Index, which is composed of the 100 largest companies in the Common Market (see chart). This Index has just sunk to a new low after moving sideways for over a year. In fact, as seen on the chart, the Eurosyndicat Index looks remarkably like our own A-D ratio when compared to the D-J Industrial Average.



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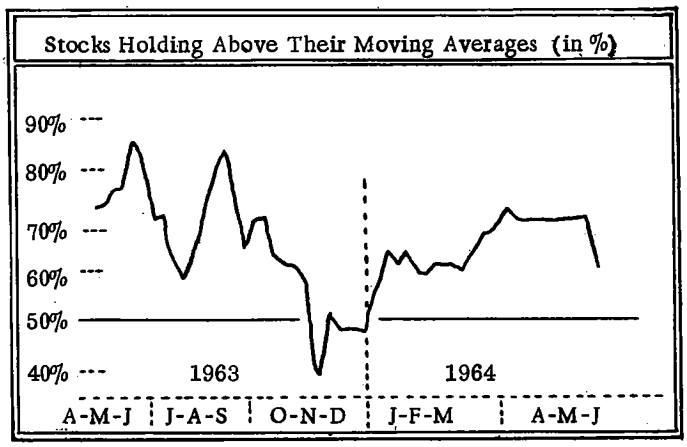
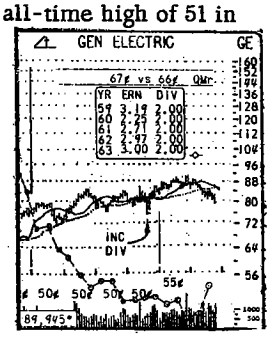
Pressure on international money markets continues in the face of U. S. "easy money" policies and a 3 1/2% U. S. discount rate. Last week the Dutch bank rate (comparable to the U. S. discount rate) rose from 4 to 4 1/2% (the Dutch market is an influential one). Reflecting balance-of-payments difficulties, the Danish bank rate was raised (June 10) a full percentage point to 6 1/2%.

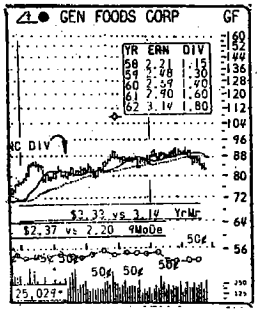
STOCKS: Of 432 stocks which are tabulated here weekly, 257 (60%) are now holding above their long-term or 200-day moving averages. This represents a drop of 10% (see chart) in the bullish percentage since last week and is the sharpest drop since the November, 1963 Kennedy panic. Nevertheless, this study will remain bullish as long as the percentage holds above the 50% level.

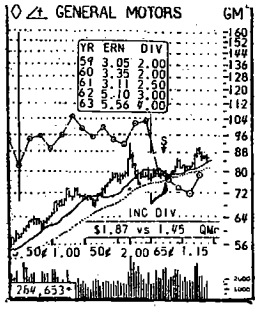


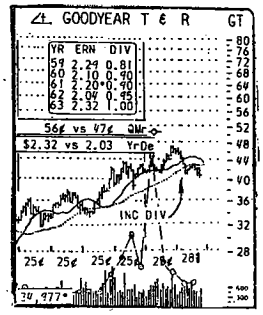
In the last Letter, I reviewed 10 of the stocks which make up the D-J Industrial Average. Since this sector has comprised (together with the Rail Average) the real strength of the market over the past year, I feel it is most important to continue this discussion. (After all, if the big stocks turn weak, there are few islands of strength left in this market. And it is worth remembering that newspaper headlines do not hold up the N. Y. S. E. — only bullish stock trends can do that).

GE "topped out" within a few points of its 1960 all-time high of 99. The stock now appears weak, it has dropped below its 200-day moving average (dotted line on chart), and its relative strength (R. S.) performance as compared to the S & P 500 Index is poor. GE's R. S. line has sunk to its lowest level since 1961 (advance notice on GE was provided in Letter 252).....GF has turned down after falling 15 points short of its all-time high of 107 (recorded in 1961). The stock is now below its 200-day moving average and its R. S. has dropped to a four-year low, a bearish picture.....GM has been reviewed here many times. The all-time high of 91 3/8 (October, 1963) still stands, and the recent rally attempt seems to have fizzled. Despite all the good auto news, it has been eight months since the high in GM. 200-day moving average for GM is 82, and that's the number to watch.....GT struck its all-time high of 51 in 1959. Since then it's been a losing battle. The 1962-64 recovery in GT hit a "double top" at 47 in March, 1964. Stock now appears "tired", and if it touches 40 I would say it was "through". GT is below its 200-day moving average.

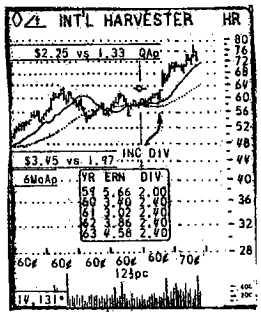


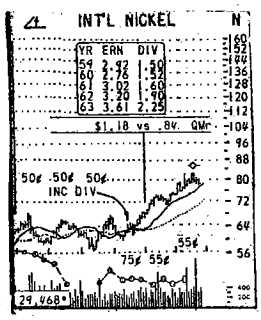


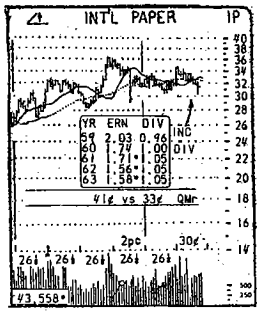


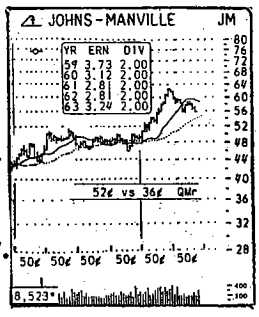


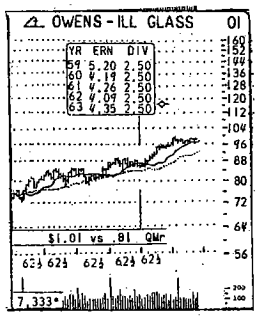
HR around its all-time high looks bullish; what more can we say about it.....N touched its all-time high of 86 in 1961. The stock may be trying for that area again. N is right on its 10-week moving average (solid black line) and as long as it holds above 75 it has a chance.....IP , incredibly enough, recorded its all-time high of 48 in 1956. The stock looks poor now, and although it is below its 200-day moving average, important support comes in at 30..... JM touched an all-time high of 75 in 1961. It's beginning to look a bit toppy, and I would not like to see JM break below 54. R. S. has now dropped to a four-month low, but this could be just a pause.....OI was at an all-time high of 116 in 1960. The stock has moved evenly with the market since 1962, and for this reason its R. S. line is absolutely flat. One of the stronger Dow stocks and bullish as long as it holds above 96.....PG is now 20% under its all-time (1961) high of 101. The stock provides a "neutral" appearance but should be considered bullish as long as it holds above 77.

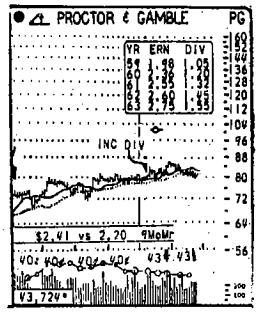








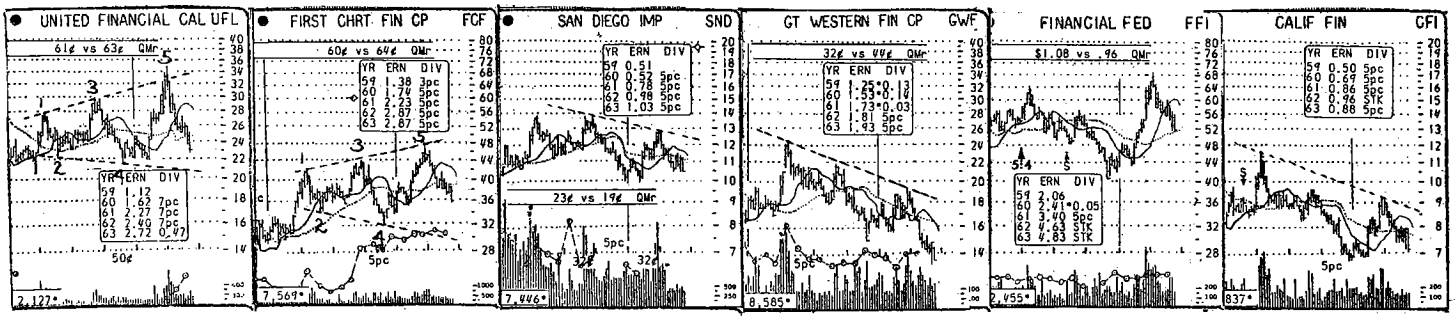




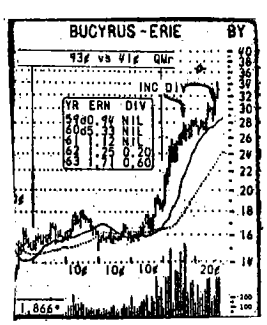
So that is the story on the second ten Dow stocks. Six out of the ten may be considered bullish; these six are GM, HR, N, JM, OI, and PG.

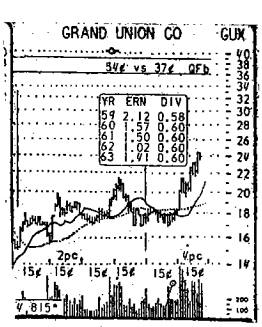
As far back as last October (Letter 235) I drew attention to the weakness in financial stocks of all types — finance companies, small loan companies and savings and loan companies. This weakness continues, but the downward trend in the savings & loan sector is now so marked and so persistent that it is worth bringing to the attention of subscribers again.

The weekly charts above follow the action in six leading (representative) S & L companies. Over the past year or so these stocks have dropped from 20 to 50% in price against a generally rising trend in their earnings. The suggestion is that there is something fundamentally wrong here — something which is causing insiders to "bail out". Since the S & L's have financed a great portion of the nation's housing (particularly out here in the West) and since these stocks control $ billions in assets, this picture will be worth watching with utmost care. The liquidation in S & L stocks is continuing right up to the time of this writing, and I would not advise readers to hold any of these issues (note the perfect broadening tops in First Charter and United Financial).



With all the talk of weakness, the three stocks to the right stand out as issues which are going up or want to go up. BY (first recommended here at 18) has now about doubled and is perhaps the strongest stock on the board. Vulcan is acting extremely well as is Grand Union. Token commitments in these stocks might prove interesting for nimble traders.





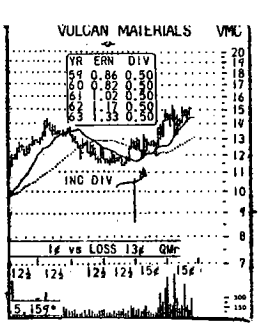


Chart 3-A and all individual stock charts courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas. Chart of Eurosydicat Index courtesy of The Investor, 50 Denmark Hill, London S. E. 5, England.